

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50197; File No. SR-ISE-2004-18)

August 13, 2004

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendments No. 1 and 2 Thereto to Amend the Market Maker Information Barrier Requirements under ISE Rule 810

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on May 26, 2004, the International Securities Exchange, Inc. (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Exchange amended the proposal on August 6, 2004,³ and August 13, 2004.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to replace the defined term “Chinese Wall” with the defined term, “Information Barrier” in ISE Rule 810. The Exchange also proposes to amend ISE Rule 810 to eliminate the requirement that a market maker maintain an Information Barrier in the limited circumstances where (i) a market maker, or broker-dealer affiliated with such market

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ On August 6, 2004, the Exchange filed a Form 19b-4, which replaced the original filing in its entirety (“Amendment No. 1”).

⁴ On August 13, 2004, the Exchange filed a Form 19b-4, which replaced the original filing and Amendment No. 1 in their entirety (“Amendment No. 2”).

maker, engages solely in proprietary trading and does not, under any circumstances, maintain customer accounts or solicit orders or funds from or on behalf of Public Customers⁵ or broker-dealers; and (ii) the sole extent to which such market maker, or broker-dealer affiliated with such market maker, handles listed options orders as agent on behalf of Public Customers or broker-dealers consists of handling such orders pursuant to an exchange sponsored Directed Order Program. Additionally, the Exchange proposes to make a non-substantive clarification and certain non-substantive technical changes to ISE Rule 810(a)(3).

The text of the proposed rule change appears below. New text is in italics. Deleted text is in brackets.

Rule 810. Limitations on Dealings

(a) General Rule. A market maker on the Exchange may engage in Other Business Activities, or it may be affiliated with a broker-dealer that engages in Other Business Activities, only if there is an Information Barrier [Chinese Wall] between the market making activities and the Other Business Activities. “Other Business Activities” means:

- (1) conducting an investment or banking or public securities business;
- (2) making markets in the stocks underlying the options in which it makes markets; or
- (3) [functioning as an Electronic Access Member] handling listed options orders as agent on behalf of Public Customers or broker-dealers;
- (4) conducting non-market making proprietary listed options trading activities.

⁵ ISE Rule 100(a)(32) defines “Public Customer” as “a person that is not a broker-dealer in securities. ISE Rule 100(a)(33) defines “Public Customer Order” as “an order for the account of a Public Customer.”

(b) Information Barrier [Chinese Wall]. For the purposes of this rule, an Information Barrier [Chinese Wall] is an organizational structure in which:

(1) The market making functions are conducted in a physical location separate from the locations in which the Other Business Activities are conducted, in a manner that effectively impedes the free flow of communications between DTRs and persons conducting the Other Business Activities. However, upon request and not on his own initiative, a DTR performing the function of a market maker may furnish to a person performing the function of an Electronic Access Member or other persons at the same firm or an affiliated firm (“affiliated persons”), the same sort of market information that the DTR would make available in the normal course of its market making activity to any other person. The DTR must provide such information to affiliated persons in the same manner that he would make such information available to a non-affiliated person.

(2) There are procedures implemented to prevent the use of material non-public corporate or market information in the possession of persons on one side of the barrier [wall] from influencing the conduct of persons on the other side of the barrier [wall]. These procedures, at a minimum, must provide that:

(i) the DTR performing the function of a market maker does not take advantage of knowledge of pending transactions, order flow information, corporate information or recommendations arising from the Other Business Activities; and

(ii) all information pertaining to the market maker’s positions and trading activities is kept confidential and not made available to persons on the other side of the Information Barrier [Chinese Wall].

(3) Persons on one side of the barrier [wall] may not exercise influence or control over persons on the other side of the barrier [wall], provided that:

(i) the market making function and the Other Business Activities may be under common management as long as any general management oversight does not conflict with or compromise the market maker's responsibilities under the Rules of the Exchange; and

(ii) the same person or persons (the "Supervisor") may be responsible for the supervision of the market making and Electronic Access Member functions of the same firm or affiliated firms in order to monitor the overall risk exposure of the firm or affiliated firms. While the Supervisor may establish general trading parameters with respect to both market making and other proprietary trading other than on an order-specific basis, the Supervisor may not:

(A) actually perform the function either of market maker or Electronic Access Member;

(B) provide to any person performing the function of an Electronic Access Member any information relating to market making activity beyond the information that a DTR performing the function of a Primary Market Maker may provide under subparagraph (b)(1), above; nor

(C) provide a DTR performing the function of market maker with specific information regarding the firm's pending

transactions or order flow arising out of its Electronic Access Member activities.

(c) Documenting and Reporting of Information Barrier [Chinese Wall]

Procedures. A Member implementing an Information Barrier [Chinese Wall] pursuant to this Rule shall submit to the Exchange a written statement setting forth:

- (1) The manner in which it intends to satisfy the conditions in paragraph (b) of this Rule, and the compliance and audit procedures it proposes to implement to ensure that the Information Barrier [Chinese Wall] is maintained;
- (2) The names and titles of the person or persons responsible for maintenance and surveillance of the procedures;
- (3) A commitment to provide the Exchange with such information and reports as the Exchange may request relating to its transactions;
- (4) A commitment to take appropriate remedial action against any person violating this Rule or the Member's internal compliance and audit procedures adopted pursuant to subparagraph (c)(1) of this Rule, and that it recognizes that the Exchange may take appropriate remedial action, including (without limitation) reallocation of securities in which it serves as a market maker, in the event of such a violation;
- (5) Whether the Member or an affiliate intends to clear its proprietary trades and, if so, the procedures established to ensure that information with respect to such clearing activities will not be used to compromise the Member's Information Barrier [Chinese Wall], which procedures, at a minimum, must be the same as those used by the Member or the affiliate to clear for unaffiliated third parties; and

(6) That it recognizes that any trading by a person while in possession of material, non-public information received as a result of the breach of the internal controls required under this Rule may be a violation of Rules 10b-5 and 14e-3 under the Exchange Act or one or more other provisions of the Exchange Act, the rules thereunder or the Rules of the Exchange, and that the Exchange intends to review carefully any such trading of which it becomes aware to determine whether a violation has occurred.

(d) Exchange Approval of Information Barrier [Chinese Wall] Procedures. The written statement required by paragraph (c) of this Rule must detail the internal controls that the Member will implement to satisfy each of the conditions stated in that Rule, and the compliance and audit procedures proposed to implement and ensure that the controls are maintained. If the Exchange determines that the organizational structure and the compliance and audit procedures proposed by the Member are acceptable under this Rule, the Exchange shall so inform the Member, in writing. Absent the Exchange finding a Member's Information Barrier [Chinese Wall] procedures acceptable, a market maker may not conduct Other Business Activities.

(e) Clearing Arrangements. Subparagraph (c)(5) permits a Member or an affiliate of the Member to clear the Member's market maker transactions if it establishes procedures to ensure that information with respect to such clearing activities will not be used to compromise the Information Barrier [Chinese Wall]. In this regard:

(1) The procedures must provide that any information pertaining to market maker securities positions and trading activities, and information derived from any clearing and margin financing arrangements, may be made available only to those employees (other than employees actually performing clearing and margin functions) specifically authorized under this Rule to have access to such information or to other

employees in senior management positions who are involved in exercising general managerial oversight with respect to the market making activity.

(2) Any margin financing arrangements must be sufficiently flexible so as not to limit the ability of any market maker to meet market making or other obligations under the Exchange's Rules.

(f) Exceptions to the Information Barrier [Chinese Wall] Requirement.

(1) A market maker shall be exempt from paragraph (a)(3) of this Rule to the extent the market maker complies with the following conditions:

(A)[(1)] such Member [functions as an Electronic Access Member] handles orders as agent only for the account of entities that are affiliated with the Member and solely in options classes [(i)] contained in Groups to which the Member is not appointed as a market maker pursuant to Rule 802 or [(ii)] in which the Member is prohibited from acting as a market maker pursuant to regulatory requirements; [and] or

[(2) the Member enters orders as an Electronic Access Member only for (i) the proprietary account of the Member; or (ii) the account of entities that are affiliated with the Member.]

(B) such market maker handles orders as agent solely with respect to a Directed Order Program, as defined in Supplementary Material .01 below.

(2) A market maker shall be exempt from paragraph (a)(4) of this Rule to the extent the Member, or a broker-dealer with which such Member is affiliated:

(A) engages solely in proprietary trading and does not, under any circumstances, maintain customer accounts or solicit or accept orders or funds from or on behalf of Public Customers or broker-dealers; and

(B) does not participate in any Directed Order Programs, as defined in Supplementary Material .01 below, or utilize any other order types which call for the participation of, or interaction with, Public Customers or broker-dealers.

Supplementary Material to Rule 810

.01 For purposes of paragraph (f)(1)(B) and (f)(2)(B) of Rule 810 only, a Directed Order Program means rules of an options exchange that (1) permit an options market maker to handle orders directed to it anonymously through an exchange system; (2) require the market maker to accept directed orders from all sources eligible to direct orders using such exchange system; and (3) require the options market maker to execute such directed orders on such exchange under specified order handling procedures. A Directed Order Program shall not include any rules of an exchange that permit a market maker to accept orders directly, without being routed through an exchange system, from customers or another broker-dealer, nor any rules or system that allows a market maker to handle orders on a disclosed or discretionary basis.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in

Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to replace the defined term “Chinese Wall” with the defined term “Information Barrier” in ISE Rule 810. The Exchange does not, however, propose to change the definition or meaning of the defined term. Under ISE Rule 810, a member must maintain an Information Barrier between its ISE market making operations and “Other Business Activities.” Other Business Activities are defined as (i) conducting an investment or banking or public securities business; (ii) making markets in the stocks underlying the options in which it makes markets; or (iii) functioning as an Electronic Access Member (“EAM”).⁶ Requiring an Information Barrier between Other Business Activities and a member’s market making activities assures that market makers compete on equal terms. Of particular importance is separating EAM and market making activity, as this assures that market makers do not use information regarding pending orders to their advantage.

To comply with the Information Barrier requirement, a Member must physically locate its market making personnel separately from personnel conducting Other Business Activities. This means that the same person at a firm may not engage in ISE market making activities while also handling agency orders or trading for the firm’s non-market making options proprietary account. ISE Rule 810 currently contains a narrow exemption to the Information Barrier requirement that allows a firm to place orders in options for which they are not making markets on the ISE, so long as such orders are proprietary orders (that is, not customer orders) or orders

⁶ See ISE Rule 810(a).

for an affiliate. ISE Rule 810 does not require that a member separate its ISE market making activities from its options market making activities that occur on other options exchanges.

With the instant proposed rule change, the Exchange proposes two additional exemptions from the Information Barrier requirement:

Proprietary Options Trading: Certain market makers, or broker-dealers with whom such market makers are affiliated, engage solely in proprietary trading. Accordingly, such firms do not maintain customer accounts and do not solicit or accept orders from or on behalf of Public Customers or broker-dealers. As a result, the ISE believes that the market maker would not have access to non-public order flow information that might improperly influence its market making trading activities. Under these circumstances, the Exchange believes requiring an Information Barrier between the firm's market making and proprietary trading activity places an unnecessary burden on the member.⁷

Directed Order Programs: The Exchange also proposes to amend ISE Rule 810 to allow a market maker to handle orders as agent according to the rules of "Directed Orders Programs."⁸ Allowable Directed Order Programs are narrowly defined rules of an options exchange that (1) permit an options market maker to handle orders directed to it anonymously through an exchange system; (2) require the market maker to accept directed orders from all sources eligible to direct orders using such exchange system; and (3) require the options market maker to execute such

⁷ The ISE believes that this section of its proposal is similar to a proposed rule change by the Pacific Exchange, Inc. that was approved by the Commission. See Securities Exchange Act Release No. 49264 (February 17, 2004), 69 FR 8510 (February 24, 2004)(SR-PCX-2003-49).

⁸ ISE has proposed to define "Directed Order Program" under proposed Supplementary Material .01 to ISE Rule 810.

directed orders on such exchange under specified order handling procedures. A Directed Order Program specifically does not include any rules of an exchange that permit a market maker to accept orders directly, without being routed through an exchange system, from customers or another broker-dealer, nor any rules or system that allows a market maker to handle orders on a disclosed or discretionary basis. Such narrowly defined Directed Order Programs themselves contain rules designed to ensure that market makers do not gain an informational advantage in handling agency orders. The Exchange believes that this change is necessary to clarify that an ISE market maker need not have an Information Barrier between its ISE market making operations and options market making operations on other exchanges by virtue of their participation in a Directed Order Program, such as that currently approved for the Boston Options Exchange (“BOX”), a facility of the Boston Stock Exchange, Inc.⁹ The Exchange believes that requiring an Information Barrier in this situation would be unnecessarily burdensome to its Members because they are given little discretion in handling orders under these Commission approved Directed Order Programs.

The Exchange also proposes to clarify the definition of “Other Business Activities” under ISE Rule 810(a). Currently, the definition includes “functioning as an Electronic Access Member.” The use of this term in ISE Rule 810(a) has caused confusion among its members. Therefore, the Exchange proposes to specify that Other Business Activities include: (i) handling listed options orders as agent on behalf of Public Customers or broker-dealers, and (ii) conducting non-market making proprietary listed options trading activities. The Exchange

⁹ See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004)(SR-2002-15). The ISE has proposed a similar rule. See SR-ISE-2004-16.

believes that this proposed change is consistent with the interpretation that has been applied by the Exchange since adoption of ISE Rule 810.

2. Statutory Basis

The Exchange believes that the basis under the Act for this proposed rule change, as amended, is the requirement under Section 6(b)(5) of the Act¹⁰ that the Exchange have rules that are designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, the Exchange believes the proposal would remove an unnecessary burden on its members to maintain information barriers in narrow circumstances where the Exchange believes there is no regulatory need to do so.

B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds

¹⁰ 15 U.S.C. 78f(b)(5).

such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change; or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-ISE-2004-18 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-ISE-2004-18. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those

that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the ISE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-ISE-2004-18 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Margaret H. McFarland
Deputy Secretary

¹¹ 17 CFR 200.30-3(a)(12).